IT 96-34
Tax Type: INCOME TAX
Issue: Apportionment: One Factor/Three Factor Application

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	Docket No.
v.	)	Tax Years: 12/31/83- 12/31/87
TAXPAYER A and TAXPAYER B	)	James P. Pieczonka Administrative Law Judge
Taxpayer(s).	)	

RECOMMENDATION FOR DISPOSITION ON REMAND

Appearances:

James P. Pieczonka, Administrative Law Judge, presided at a hearing on remand in the above entitled cause. Special Assistant Attorney General, William J. Seitz, represented the Department. Richard M. Lipton and Catherine A. Van Horn of Sonnenschein Nath & Rosenthal appeared and represented the Taxpayer at the remand hearing.

Synopsis:

The instant case was remanded following a Memorandum and Decision issued October 4, 1994 by the Honorable Judge Randye A. Kogan entitled *Northwest Airlines, Inc. v. Department of Revenue*, Circuit Court of Cook County, 93 L 50535. Pursuant to Judge Kogan's Order, a remand hearing was held on October 17, 1995. (Transcript ("Tr. p. or pp.")) as provided in Section 100.9600 of the Department's Regulations (former Section 100.9805). *See* 86 Ill. Adm. Code, Ch. I, Section 100.2000 *et. seq.* /[1] The original administrative hearing was conducted by ALJ Harve D. Tucker, formerly with the Department (Administrative Record ("R")).

[1]. On August 23, 1993, the Department issued a Notice of Recodification, Illinois Administrative Code, Title 86, Chapter I, Part 100, Income Tax, which renumbered many of the sections in the Department's income tax regulations. Although this matter involves years prior to the recodification, the current recodified citations are used. The former section numbers are provided in parenthesis for reference.

The instant case arose as a result of three protested income tax audits conducted by the Illinois Department of Revenue (hereinafter referred to as the "Department") of TAXPAYER A and TAXPAYER B (hereinafter collectively referred to as "TAXPAYER A", or "Taxpayer"). /[2] The audits conducted by the Department related to Taxpayer's returns filed under the Illinois Income Tax Act (hereinafter referred to as the "Act"). *See* 35 **ILCS** 5/101 *et seq*. TAXPAYER A is contesting, pursuant to the Administrative Review Act, three Notices of Deficiency issued by the Department.

The disputed issue of the audits is whether the Department properly included certain so called Illinois "fly-over" revenue miles in the Illinois numerator of the Taxpayer's apportionment fraction (hereinafter referred to as "fly-over" or "overflight" miles). More specifically, the dispute principally involves the construction and interpretation of Section 304(d)(1) of the Act. The Department had concluded that those Illinois fly-over revenue miles should be included in the numerator set forth in Section 304(d). Both TAXPAYER A and the Department argued their respective positions before Judge Kogan.

In addition to Section 304(d), during the course of this litigation, TAXPAYER A and the Department also made other arguments as to whether Illinois fly-over revenue miles should be included under the Act:

a) whether inclusion is preempted under the Federal Aviation Act;

b) whether the Department is prohibited from including the fly-over miles by the Illinois Administrative Procedure Act, 5 **ILCS** 100/1-1 *et seq*.; and

c) whether inclusion would violate the Commerce Clause of the U.S. Constitution.

Judge Kogan's Memorandum and Decision reversed as contrary to law, the ALJ's determination that Illinois fly-over revenue miles are included in the Illinois numerator under Section 304(d)(1) of the Act. Her finding was based

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[2]. Pursuant to acquisition and merger in 1986, TAXPAYER A is the successor to TAXPAYER B for purposes of this litigation. (R. 1092, Stip. 3.)

upon her interpretation of the language of the statute and the legislative intent regarding the use of the language "in" this state chosen by the General Assembly.

The remand to the Department for Recommendation On Remand relates to the second part of Judge Kogan's analysis. While she found against the Department based on her reading of Section 304(d), Judge Kogan stated that the Department may include overflight miles in the numerator of the apportionment formula if the requirements under alternative apportionment under Section 304(f) were met. Consequently, Judge Kogan remanded this matter to the Department for specific findings on whether the Department has demonstrated the prerequisites which the Department is required to show to invoke Section 304(f) in this case. However, the Section 304(f) issue would be applicable *only* if it were found that Illinois fly-over revenue miles are *not required* to be included in the Illinois numerator under the statutory formula in Section 304(d). Accordingly, the Department argued the Section 304(f) issue in the alternative in the event there is a finding against the Department on the Section 304(d) issue.

In addition to Section 304(d)(1), both parties have also made arguments that Illinois fly-over revenue miles should or should not be included pursuant to Section 304(f) of the Act. Specifically, it has been argued by both parties that if Section 304(d)(1) did not support their respective positions, to find otherwise would not fairly represent the extent of TAXPAYER A's business activity in the State of Illinois. The Department's position is that a portion of TAXPAYER A's Illinois business activity would not be measured if the Illinois fly-over miles were not included under Section 304(d)(1). TAXPAYER A argued that the fly-over miles activity is separate and distinct from flying into and out of Illinois airports and an inclusion of fly-over miles under Section 304(d)(1) would not fairly represent the extent of what it considered to be its Illinois business activities.

In light of her order of remand on the Section 304(f) issue, Judge Kogan's Memorandum and Decision did not specifically address other issues raised by the

Taxpayer. She ordered that the remand decision should address other relevant issues. At the remand hearing, the parties noted recent developments in the law on the arguments and restated their positions as set out in their initial administrative hearing briefs and arguments since the original hearing of December 7, 1992. /[3]

Pursuant to Judge Kogan's Order for a Remand Recommendation, the entire record and issues in this case were reviewed to determine the effect of her decision on the other issues in the case. An issue reviewed was the imposition of the Section 1005 penalty. The imposition of Section 1005 penalties applies *only* if Illinois fly-over revenue miles are *required* to be included in the Illinois numerator under the statutory formula in Section 304(d). The Taxpayer argued this issue in the alternative only if an ultimate finding in favor of the Department on the Section 304(d) issue is made.

The issues presented for review are:

1. In the event "fly-over revenue miles" cannot be included under the provisions of Section 304(d)(1), whether the Department can include certain so called Illinois "fly-over revenue miles" in the numerator of the apportionment fraction pursuant to Section 304(f) of the Act in order to fairly represent the extent of Taxpayer's business activity in the State of Illinois?

2. In the event the Department properly included the fly-over revenue miles in TAXPAYER A's Illinois numerator, whether TAXPAYER A has demonstrated "reasonable cause" to abate the penalties under Section 1005 of the Act for their underpayment of tax on the returns as filed?

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[3]. A New Development on the arguments cited was that the Federal Aviation Act is now at 49 **USCA** Sec. 40101 *et seq*. TAXPAYER A's preemption and federal miles arguments cited were based on the now repealed provisions of 49 **USCA** Appx. Sec. 1301 *et seq.* (Tr. pp. 33-34) The provisions currently have different statutory language. Section 1513(f) is now Section 40116(c). Section 1508(a) is now Section 40103(a). Another New Development is a significant Commerce Clause case recently issued by the U.S. Supreme Court in *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 115 S.Ct. 1331 (1995). (Tr. p. 35-36) Among the issues analyzed by the *Jefferson Lines* Court was the difference between apportionment of a tax base as opposed to a sales tax on a transaction.

Findings of Fact:

1. TAXPAYER A is a Minnesota corporation with its principal place of business in Minnesota. (R. 1092, Stip. 2)

2. TAXPAYER A is a commercial air carrier which is engaged in an integrated passenger and cargo transportation business in interstate commerce between cities in the United States and in international commerce. (R. 972-975) The business operates between city pairs through a system of routes in which Illinois, the United States, and international routes are a part. (R. 337-338; 575-581; 972-975)

3. TAXPAYER A conducted operations into and out of Illinois airports, with regular contact with Illinois through aircraft landings, departures, boarding and deplaning of passengers, and loading and unloading of cargo. In the State of Illinois at any given time, TAXPAYER A has some aircraft in the air above Illinois on a flight segment between city pairs it serves, some aircraft descending to land, some taking off, and some on the ground loading and unloading.

4. Taxpayer is a transportation company which is required to apply the apportionment formula under Section 304(d) of the Act applicable to persons engaged in furnishing transportation services. On its Illinois income tax returns as filed, TAXPAYER A apportioned its business income to Illinois pursuant to Section 304(d)(1) on the basis of a fraction, the numerator of which was the lllinois revenue miles of intrastate flights and interstate flights which stopped or originated from Illinois airports and the denominator of which was revenue miles flown by Taxpayer everywhere. Revenue miles are comprised of revenue passenger miles and freight ton miles. (R. 1097-1098)

5. Taxpayer's returns as filed did not include as Illinois revenue miles those revenue miles which it considered to be "fly-over" or "overflight" miles and not Illinois miles. "Fly-over" or "overflight" revenue miles are: (1) revenue passenger miles; and (2) freight ton miles, each of which relate to flights that do not take off from or land at Illinois airports, but where the

normal route of such flights is over Illinois. (R. 1095) In each instance, the mileage over Illinois is multiplied by the number of revenue passengers (or freight ton miles), resulting in "fly-over revenue miles". (R. 1082-1087) Such fly-over miles are included in the denominator as part of "everywhere" miles. (R. 1082)

6. During the first audit covering TAXPAYER A's 1983 through 1985 tax years, the Department found that the Taxpayer's apportionment records showed a category for unknown revenue miles and another category for fly-over miles. The adjustment to include Illinois fly-over miles to the numerator was made after the auditor found that the fly-over miles are not allocated to any other state's numerator. (R. 188, 201-202)

7. During the second audit covering TAXPAYER B's 1985 through 1986 year end returns, the Department reviewed TAXPAYER B's "Summary of Passenger and Cargo Statistics by State" and found that TAXPAYER B had a substantial amount of segment miles for a category called "Off Route". (R. 585, 594 (Illinois); R. 589, 603, (Off Route); 593, 611 (All System)) The Department noted that TAXPAYER B's originally filed returns only included revenue miles it considered to be "in" Illinois, omitting the miles it considered to be "over" the State of Illinois from the calculation. On audit, the Department took the Illinois fly-over revenue miles into account in calculating the apportionment factor between the two categories under Section 304(d), revenue passenger miles and cargo ton miles. (R. 344, 346, 349). The Department then made calculations to determine the applicable Illinois numerator and everywhere denominator. (R. 365, 384-389). This involved determining the Illinois miles for the portion of the "off route" segment state miles which were in the airspace above the State of Illinois for those city pairs where neither the origination or destination was an Illinois airport, (R. 664-796)

8. During the third audit covering TAXPAYER A's 1986 and 1987 tax years, an audit adjustment was made to add Illinois fly-over miles to the numerator. (R. 802) Prior to this audit, the other audits had been protested. (R. 804-

806) Fly-over miles were included in the revenue miles apportionment factor calculation after weighting was done without the fly-over miles (R. 822-824)

9. For each audit, the Department adjusted the numerator of TAXPAYER A's Section 304(d) revenue miles apportionment fraction as originally filed by including Illinois fly-over revenue miles in Illinois miles. As adjusted, the Illinois flight segments of aircraft flight pairs which normally fly in the airspace above the State of Illinois were included as Illinois revenue miles. (R. 1097-1098)

10. The Department's Statement explaining the adjustments in the first TAXPAYER A Notice of Deficiency cited Section 304(d)(1) and referred to the inclusion of fly-over revenue miles as being made to "fairly and reasonably represent" the extent of TAXPAYER A's business activity in Illinois. (R. 1019, 188) The Statement to the second TAXPAYER A Notice referred to Section 304(d) and the auditor's report stated that inclusion of the Illinois fly-over miles would "more fairly represent" the Taxpayer's business activity. (R. 1072, 802)

11. The Department's Statement attached to the TAXPAYER B Notice stated that the Section 304(d) one factor revenue mileage factor is adjusted as shown on an computation sheet which was attached. (R. 1039-1042)

12. In protests to the Notices of Deficiency issued by the Department, Taxpayer made the contrary argument, that inclusion of the Illinois fly-over miles in the numerator would not "fairly represent" their business activities. In the protest to the first Notice of Deficiency issued in this case, TAXPAYER A made a contention that inclusion of Illinois fly-over miles in the numerator "does not result in a fair representation of the taxpayer's business activity attributable to the State of Illinois". (R. 1031) They argued that reflecting those miles as Illinois business activity would be "taxing TAXPAYER A income which is earned outside of the State". (R. 1033-1036) The protest to the second Notice of Deficiency issued to TAXPAYER A did not make a Section 304(f) argument. (R. 1076-1081)

13. In the protest to its Notice, TAXPAYER B contended that a "majority of the Illinois fly-over miles have effectively already been included in the numerator of other state's sales factors thereby resulting in double taxation". (R. 1047) TAXPAYER B stated that "... we need to analyze the application of the various state formulas to determine if there is a significant amount of mileage that is being double counted". (R. 1048) Taxpayer took the position that allowing Illinois to include fly-over miles (at least as it relates to some of the city pairs) would result in "double counting". (Id.) TAXPAYER B cited Section 304(f) in support of its contentions and contended that including Illinois fly-over miles in the numerator is not "properly apportioned" to local activities within the State of Illinois. (R. 1050-1051)

14. The detailed apportionment percentage calculations associated with measuring Taxpayers business activity in Illinois for the years at issue under each of the different formulas depending on whether Illinois fly-over miles are either included (as asserted by the Department) and not included (as asserted by the Taxpayer) in the Illinois numerator:

Year	Taxpayer	W/O Fly-Over Included (%)	With Fly-Over Miles Included (%)	Difference
12/31/83	TAXPAYER A	0.8883	1.2971	0.4088
12/31/84	TAXPAYER A	0.7961	1.2529	0.4568
12/31/86	TAXPAYER A	0.5398	1.1224	0.5826
12/31/87	TAXPAYER A	0.5764	1.6633	1.0869
8/12/86	TAXPAYER B	1.0346	3.7650	2.7304
11/19/86	TAXPAYER B	1.0004	2.5281	1.5277
	(Joint Ex. 12-L)	(R. 1104-1107)	(R. 1101-1104)	

15. The total of Taxpayer's income tax apportionment percentages for each of the States, Counties, and Cities in which they filed income tax returns were as follows:

Year	Taxpayer	Total (%)
12/31/83	TAXPAYER A	28.0454
12/31/84	TAXPAYER A	27.1984
12/31/86	TAXPAYER A	31.8488
12/31/87	TAXPAYER A	34.3801
8/12/86	TAXPAYER B	38.0989
11/19/86	TAXPAYER B	40.1158
	(DOR. Ex. D)	(R. 184-186; Tr. p. 28)

16. Taxpayer had a substantial percentage of the total revenue passenger miles ("RPM's") that were either related to international miles or to States for which they are not taxed. Those States which have elected not to impose an income tax on airlines were identified by the Taxpayer as New York, Nevada, South Dakota, Texas, and Washington. Those percentages were as follows:

Year	Taxpayer RPM's	International RPM's	Non-Taxing States RPMs	Total RPM's	% of Total RPM's Allocated to Int'l or Non-Taxing States
12/31/83	TAXPAYER A	8,606,302,000	346,472,781	18,047,439,000	49.61%
12/31/84	TAXPAYER A	10,308,106,000	305,269,126	20,131,360,000	52.72%
12/31/86	TAXPAYER A	12,623,442,000	468,657,203	29,640,133,000	44.17%
12/31/87	TAXPAYER A	14,124,133,000	685,247,653	39,788,542,000	37.22%
1-11/86	TAXPAYER B	152,680,792	302,150,446	11,918,085,162	3.82%
Taxpayer Ex. 14)		(R. 1017; Tr. p. 29)	(R. 1017)		

17. The Department issued Notices of Deficiency to Taxpayer following three separate audits. (R. 1018-1021; 1038-1043; 1070-1075) Taxpayer filed protests and a requested a hearing. (R. 1027-1037; 1044-1054; 1076-1081)

18. On September 10, 1992, a consolidated hearing on the taxable years covering the three audits was held before former Administrative Law Judge, Harve D. Tucker, at the Department's Chicago Office. Special Assistant Attorney General, William J. Seitz, represented the Department. Richard M. Lipton and Frederic S. Lane of Sonnenschein Nath & Rosenthal appeared and represented the Taxpayer at the hearing in this matter.

19. A Joint Stipulation of Facts (1091-1107), Joint Exhibits 1-A through 12-L (R. 1018-1090), Department Exhibits A through AQ (R. 179-1015), and Taxpayer Exhibits 13 and 14 (R. 1016-1017) were introduced into the record. The Department presented the testimony of Audit Supervisor Thomas E. Donnelley. (R. 14-54). TAXPAYER A presented the testimony of three witnesses, TAXPAYER A's Director of Flight Services, WITNESS A (R. 54-89), TAXPAYER A's Manager of Customer Service at Chicago O'Hare Airport, WITNESS B (R. 90-112), and TAXPAYER A's Director of Income Taxes, WITNESS C (R. 113-135). Following the hearing, both parties submitted Briefs in support of their respective positions. (R. 1108-1161 (Department); 1162-1228 (Taxpayer)) An oral argument was held before ALJ Tucker on December 7, 1992. (R. 138-177)

20. WITNESS C testified as to the positions taken in filing and computing the Illinois apportionment factor numerator on the Illinois returns as filed. In filing the returns, he stated the position was taken that Section 304(d) does not expressly require the inclusion of Illinois overflight miles. (R. 120). Given the absence of Illinois regulations, case law, or other published authorities, they took a position on the Illinois returns which excluded the Illinois fly-over revenue miles from the returns. In reporting their Illinois revenue miles numerator, they took the position that the proper computation only required the reporting of Illinois revenue miles from city pairs originating or departing from Illinois airports. The Taxpayer also felt their position was consistent with the position they successfully took in a Montana Supreme Court case issued to them prior to the filing of their Illinois returns. (R. 121-122)

21. Administrative Law Judge Harve D. Tucker issued a Recommendation for Disposition upholding the proposed assessments of the Department of Revenue. (R. 1344-1364)

22. On the issue of the statutory interpretation of Section 304(d) of the Act, ALJ Tucker stated:

> Activities in Illinois airspace are in Illinois. There is nothing in the statute to support the taxpayer's view that only the Illinois flyover miles of originating and departing flights should be included in the numerator. By considering those miles as being *in* Illinois while considering flyover miles as being *over* Illinois is making a distinction not contemplated by the statute... (R. 1348) (emphasis original)

23. ALJ Tucker cited Section 304(f) and further stated:

> ...Although neither party need rely on IITA Section 304(f) to support its position, the regulation thereunder provides language basic to apportionment theory. The regulation uses such terms as "fairly represent" and "equitable allocation and apportionment". These are the objectives of any apportionment formula, whether they are the "standard" methods of IITA Section 304(a)-(d) or the more subjective methods authorized by IITA Section 304(f). (*Id.*)

24. ALJ Tucker upheld the imposition of the Section 1005 penalty concluding:

> The taxpayer has not presented any documentation or other competent evidence to demonstrate that the standards of reasonable cause have been met to justify abatement of the penalty. The taxpayer's position is not consistent with the language of Section 304(d). Neither is it consistent with any other state Supreme Court decision based on similar statutory language. The penalty is sustained. (R. 1363-1364)

25. The Acting Director of Revenue issued a Notice that adopted the Recommendation on May 4, 1993, and the decision became final on June 3, 1993. (R. 1343) Taxpayer filed a timely complaint for Administrative Review in the Circuit Court of Cook County on June 7, 1993.

26. This matter was heard on administrative review before the Honorable Randye A. Kogan. The parties raised six issues regarding whether findings in ALJ Tucker's decision were proper. The six challenged findings were that:

a) Illinois overflight miles are included in the numerator of the Illinois apportionment formula under Section 304(d) of the Act;

b) The Department did not violate the Illinois Administrative Procedure Act;

c) The Deficiency Notices complied with the statutory requirements and the Department could cite Section 304(f) as an alternative theory in support of the inclusion of fly-over miles in the Illinois apportionment numerator;

d) Federal law does not pre-empt the inclusion of Illinois fly-over miles in apportioning income under the Act;

e) The Commerce Clause of the U.S. Constitution is not violated by Illinois' inclusion of fly-over revenue miles; and

f) Penalties under Section 1005 of the Act should be assessed.

27. Judge Kogan's Memorandum and Decision made a finding on the first issue. Her statutory construction analysis concluded that neither the language

of the statute nor the legislative intent indicates that overflights are included in the language of Section 304(d). Judge Kogan found that the ALJ's decision to include overflight miles in the numerator pursuant to Section 304(d) is contrary to law. (slip op. at 18)

28. Judge Kogan concluded that "the plain meaning of Section 304(d) as it is written would not include overflights as 'in this state'". (slip op. at 15) Her opinion was based upon the legislative intent she found after her examination of the word "in" used in the statutory language of Section 304(d)(1). She determined that "[t]he plain meaning of 'in' does not include 'over' and further is a limitation on a geographical area, not an expansive one". (slip. op. at 15)

29. Judge Kogan stated that the words "in this State" in Section 304(d) apply a geographical limitation to the apportionment formula as applied to airlines which limits the numerator to only revenue miles from flights between city pairs where the aircraft arrives and departs from Illinois airports. Applying the rationale of a direct sales tax case, *Standard Oil Co. v. Department of Finance*, 383 Ill. 136 (1943), to an apportionment formula, she stated that:

> The words "in this State" are also present in Section 304(d); the word "overflight" is not. Therefore, it may be concluded that there is a geographical limitation as to specific revenue miles that are to be included in the numerator of the apportionment formula. Overflights are not included. (slip op. at 16-17)

30. Finding that the legislature provided only for apportionment on flight miles "in" this State, Judge Kogan concluded that the language it chose to use in Section 304(d) indicates an legislative intent to not include such flights in the numerator. (Slip op. at 18)

31. Judge Kogan remanded the case to the Department for a more specific finding on the issue raised as to whether the Department possesses the means to include overflight miles in the numerator of the apportionment formula under Section 304(f) of the Act. (slip op. at 23)

32. Notwithstanding, her order of remand on the Section 304(f) issue, Judge Kogan's Memorandum and Decision did not specifically address the other issues raised by the Taxpayer. She ordered that the supplemental decision should address those issues when relevant. (slip op. at 23)

Conclusions of Law:

I. Overview of Statutory Framework.

In general, when a corporation conducts business in more than one state, a question arises as to how much income is derived from each of the states where business is transacted. Under the apportionment methods contained in Article 3 of the Act, formulas are used to compute the percentage of a corporation's business conducted in the State of Illinois. *See* Sections 304(a)-(f). Consistent with a uniform act, the Uniform Division of Income for Tax Purposes Act ("UDITPA"), a fraction composed of an Illinois numerator and an everywhere denominator is calculated for each corporation doing business in Illinois. This percentage is then multiplied by the corporation's total taxable business income (tax base) in order to determine the portion of taxable income earned within the state.

Apportionment does not increase or decrease the tax base (total taxable income). It is a method of calculation for determining what portion of that income was earned in each of the states in which a taxpayer transacts business. The Illinois Supreme Court has previously found the General Assembly's intent behind those apportionment formulas as:

> [t]he purpose of the uniform act and article 3 of the Illinois act is to assure that 100%, and no more or no less, of the business income of a corporation doing multistate business is taxed by the states having jurisdiction to tax it. *GTE Automatic Electric, Inc. v. Allphin*, 68 Ill. 2d 326, 369 N.E.2d 841, 845 (1977). *See also Dover Corporation v. Department of Revenue*, 271 Ill. App. 3d 700, 648 N.E.2d 1089, 1094 (1st Dist.), *appeal denied*, 163 Ill. 2d 552 (1995).

Generally, Section 304(a) of the Act directs that multistate corporations doing business in Illinois must apply a three factor apportionment formula,

based on property, payroll, and sales when apportioning business income to the State of Illinois. The General Assembly has provided for special apportionment formulas for corporations in the insurance, financial, and transportation businesses to use in apportioning their income. *See* Sections 304(b)-(d).

Companies such as TAXPAYER A which are furnishing transportation services are required to apportion their business income using the special apportionment formula in Section 304(d) of the Act. Section 304(d) is set out in general terms because the General Assembly intended that it apply to the diverse types of transportation companies doing business in Illinois such as airlines, railroads, barges, bus lines, trucking firms, and pipelines. The apportionment formula for transportation service companies in Section 304(d) uses a fraction based on revenue miles.

Section 304(d)(1) of the Act provides in part:

> ...business income (other than that derived from transportation by pipeline) shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the *revenue miles* of the person *in this State* and the denominator of which is the *revenue miles* of the person *everywhere*. (emphasis added)

Section 304(d)(1) defines a "revenue mile" as "the *transportation* of 1 passenger or 1 net ton of freight the *distance of one mile* for a consideration". (emphasis added) Where a person is engaged in the transportation of both passengers and freight, the ratio is weighted between revenue passenger miles and revenue freight miles.

The Section 304(d)(1) dispute concerns whether the language "revenue miles ... *in this state*" includes the Illinois "fly-over" miles. TAXPAYER A argues that Illinois fly-over revenue miles are not revenue miles "in this state" and therefore are not included in the calculation of the revenue miles attributable

to Illinois in the numerator. /[4] Judge Kogan found on this principal issue in the case on the statutory interpretation of Section 304(d) by reversing the decision of the ALJ as contrary to law. *Northwest Airlines, Inc. v. Department of Revenue*, No. 93 L 50535 (October 4, 1994).

Both parties agree that TAXPAYER A is required to apportion its business income to Illinois under Section 304(d)(1). However, as pointed out by Judge Kogan, both parties reach opposite results as to how the statutory language should be construed. (slip op. at 13) The Section 304(d) arguments differ in the focuses of the parties upon how the statute and evidence in the case should be interpreted.

TAXPAYER A's construction was that the phrase "in this State" contained in Section 304(d)(1) distinguishes between revenue miles "in" Illinois and revenue miles "over" Illinois. Because overflights are over, and not in, Illinois, fly over revenue miles cannot be included in the numerator of the apportionment fraction in Section 304(d). As drafted, Section 304(d) includes in the numerator of the Taxpayer's apportionment fraction the revenue miles which are "in" Illinois, but does not include fly-over revenue miles which are "over" Illinois. Therefore, the numerator of the apportionment fraction is limited to miles "in" Illinois: Illinois mileage on flights that land in or take off from Illinois. TAXPAYER A's testimony at the original hearing was consistent with its focus that "in" Illinois refers to physical contact with the ground on a flight by flight basis.

TAXPAYER A argued that the General Assembly has recognized the distinction between flights "in" a State and flights "over" a State in other non-taxing statutory provisions relating to specifically to aircraft. This distinction

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[4]. The issue of the inclusion of Illinois fly-over miles does not mean that Illinois is not levying a tax on overflights or on transactions relating to a flight. The Section 304(d) apportionment method measures the amount of the tax. The General Assembly uses revenue miles to measure business activity. The subject of the tax is the taxpayer's income derived from the many factors that go into how much net income an airline derives (e.g., labor costs, debt service, fuel costs, fares, etc.)

was viewed as an indication of a legislative intent to draw a distinction in the Act. Further, the Illinois fly-over revenue miles are "nowhere" miles flown in a strictly federal environment. Such aircraft are flying in federal airspace over the State of Illinois and there has been preemption under the federal statutes from treating overflights as miles in Illinois.

The Department's construction was that the phrase "in this State" contained in Section 304(d)(1) can only be interpreted by including all revenue miles in the airspace above the State of Illinois, including fly-over miles, in the numerator of the apportionment fraction as miles "in" Illinois. This position is consistent with the plain language of the statute and the intention of the General Assembly behind Article 3 of the Act. The Department argued that to otherwise interpret the scope of Section 304(d) would create an inconsistency between the airline industry and other taxpayers which furnish transportation services. The Department's focus was on the overflights as being one part of an integrated multistate business of operating an airline and revenue miles measure that activity among Illinois and other states.

The Department argued that unless fly over miles are assigned to some state, TAXPAYER A has income that is not apportioned to any state, in effect creating "nowhere" miles, generally miles between the departure state and the arrival state. While the inclusion of international and non-taxing state miles in the denominator makes 100% apportionment impossible, the inclusion of Illinois fly-over miles in the numerator works towards that objective. Finally, there has been no preemption under the federal statutes.

The General Assembly has provided a relief provision under Section 304(f) of the Act where if the statutorily required formula does not "fairly represent" the extent of a taxpayer's business activity in Illinois, adjustments in the statutory formula may be made.

Section 304(f) of the Act provides:

> (f) Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) do not *fairly represent* the

> extent of a person's *business activity in this State*, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
>
> (2) The exclusion of any one or more factors;
>
> (3) The inclusion of one or more additional factors which fairly represent the person's business income; or
>
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.
> (emphasis added)

The Department's regulations in Section 100.3390(c) sets out the burden and standard of proof required to be applied to a party seeking invoke Section 304(f). *See Lakehead Pipe Line Co. v. Department of Revenue*, 192 Ill. App. 3d 756, 549 N.E.2d 598 (1st Dist. 1989), *appeal denied*, 129 Ill. 2d 564 (1990)

For taxable years ending on or after January 1, 1986, Section 1005 of the Act provides that:

> ...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment *unless it is shown that such failure is due to reasonable cause.* This penalty shall be in addition to any other penalty determined under this Act. (emphasis added)

II. <u>Section 304(f) Alternative Apportionment.</u>

As noted above, Judge Kogan found in favor of TAXPAYER A's construction of the Section 304(d)(1) statutory apportionment formula. Judge Kogan further stated that her analysis did not cease with her conclusion on Section 304(d). During the litigation, both the Department and the Taxpayer had raised the issue of whether inclusion of Illinois fly-over miles would more "fairly represent" the Taxpayer's level of business activity in Illinois.

Neither the Department nor Taxpayer fully developed and presented arguments as to Section 304(f) as an alternative theory (i.e., depending on the Section 304(d) conclusion) to either include or exclude Illinois fly-over revenue miles.

The October 17, 1995 remand hearing allowed both parties the opportunity to present their respective cases on the issue. The Department presented their argument based on the evidence in the record. As they had done at the original administrative hearing, the Taxpayer argued against the Department's invocation of Section 304(f) and filed a Taxpayer's Trial Brief on Adminstrative Remand. ("TP Remand Brief")

Pursuant to Judge Kogan's order, this matter was remanded to specifically consider whether the Department has demonstrated the prerequisites it would be required to meet in order to invoke Section 304(f) under that theory. In the event Illinois "fly-over" revenue miles cannot be included in numerator under Section 304(d), the instant issue is whether, in the alternative, the Director should grant the Department's petition for alternative apportionment relief under Section 304(f) of the Act on this record.

After a review of the evidence in the record, the Administrative Law Judge finds and recommends to the Director that the Department cannot invoke an alternative apportionment method including Illinois fly-over revenue miles in the numerator under these facts because it has not shown the prerequisites which are necessary for Section 304(f) relief. On the remand record, it has not been demonstrated by "clear and cogent" evidence that applying the statutory Section 304(d) formula (assuming that a proper interpetation of Section 304(d) would exclude Illinois fly-over revenue miles from the numerator) leads to a grossly distorted result under the facts of this case. Given the size of TAXPAYER A's denominator, the Department is unable met its burden of showing that the Section 304(d) statutory formula as found by Judge Kogan operates unreasonably and arbitrarily in under-attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the State of Illinois.

Section 304(f) of the Act provides for the use of certain alternative apportionment formulas:

> [i]f the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's *business activity* in this State... (Emphasis added)

The circumstances under which Section 304(f) may be invoked are governed by the Department's regulations in current Section 100.3390(c) (former Section 100.3700(a)(4)) /[5] which further provide in part that:

> ...This subsection permits a departure from the required methods applicable under *** Section 304(a) through (d) *** only where such methods do not accurately and fairly reflect business activity in Illinois. *An alternative apportionment method under this subsection may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the regularly required formula.* However, if the application of the statutory formula will lead to *a grossly distorted result in a particular case*, a fair and accurate alternative method is appropriate. * * * The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden of showing by *clear and cogent evidence* that the statutory formula would result in the taxation of extraterritorial values. * * * The burden will be met only if the statutory formula is demonstrated to operate *unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this state.* * * * Finally, the party seeking to use an alternative apportionment formula must prove that such method *fairly and accurately* apportions income to Illinois based upon *business activity in this state.* (Emphasis added.)

To justify utilization of an alternative formula in a particular case, the application of the statutory formula required by the Act must reach a grossly distorted result. The fact that applying an apportionment method other than the statutorily required method may result in a higher (or lower) amount of income subject to taxation is not of legal significance. The Illinois Supreme Court, in addressing the issue of distortion, held that a taxpayer must prove distortion by clear and cogent evidence, and that the burden of proof is not discharged by relying on bare percentages alone. *Citizens Utilities Co. v. Department of Revenue*, 111 Ill. 2d 32, 488 N.E. 2d 984, 992-993 (1986).

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[5]. Effective on November 1, 1993, the Department adopted Section 100.3390 in the regulations. *See* Section 100.3390(a) through (i). It sets out new procedures to be used by the Director in making determinations regarding petitions seeking alternative apportionment under Section 304(f) of the Act. Current Section 3390(c) requires the same burden of proof as in former Section 100.3700(a)(4).

Section 304(f) is being invoked here only if the Illinois fly-over revenue miles are not considered to be "in" Illinois under Section 304(d). In addition to their arguments (discussed below) on the burden of proof, Taxpayer argues that if revenue miles are not "in" Illinois for purposes of Section 304(d), the Illinois overflights cannot constitute "business activity" "in" Illinois for purposes of Section 304(f). (i.e., based on the same arguments they made relative to the Section 304(d) numerator, "in" Illinois under Section 304(f) refers to physical contact with the ground on a flight by flight basis and, further, the overflight aircraft are operating in federal airspace) (TP Remand Brief at 7-11) While it is true that the "business activity" which the Department seeks to include as "in" Illinois under Section 304(f) (the Illinois fly over revenue miles) was not found to be "in" Illinois by Judge Kogan under Section 304(d), it is not clear whether the same meaning would apply in a statutory construction of Section 304(f). As discussed below, the recommendation made herein regarding the invocation of Section 304(f) is founded upon the Taxpayer's other argument regarding the evidence in the record and the burden of proof in the Department's regulations. /[6]

If the Department cannot include the Illinois fly-over revenue miles under Section 304(d), to invoke Section 304(f) it has the burden of demonstrating that exclusion of Illinois fly-over revenue miles from the numerator under Section

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[6]. A case raised by both parties was *Delta Air Lines, Inc. v. Director of Revenue*, 908 S.W. 2d 353 (Mo. 1995). The *Delta Air Lines* decision was rendered on October 24, 1995 and was raised as a New Development by the parties. The Department stated at the October 17, 1995 remand hearing that it did not believe that the case would be relevant to either side because the Missouri statute is narrower than the Illinois statute. (Tr. p. 37). The Taxpayer cited *Delta Air Lines* as supporting the proposition that TAXPAYER A's overflights which do not use any Illinois facilities also do not result in business activity in Illinois. (TP Remand Brief at 12) The Missouri statute is narrower because it apportions "revenue from each service" that involves the use of "facilities in this state". V.A.M.S. Section 143.451.4 For that reason, the *Delta Air Lines* case does not provide additional support for TAXPAYER A's contention that Illinois fly-over flights are not business activity in Illinois. The *Delta Air Lines* Court interpreted the statutory term "service" as used in the Missouri statute and held that it does not require Delta to include mileage that does not use a Missouri facility in the apportionment formula. *Id.* at 356. Given this holding, the Court did not reach the issue of whether Missouri overflights are "in" Missouri.

304(d) would operate to unreasonably and arbitrarily under-attribute to Illinois a percentage of income which is out of appropriate proportion to the business it transacted in this state. Exclusion of the Illinois fly-over revenue miles from the numerator would otherwise underrepresent TAXPAYER A's Illinois business activities.

As a preliminary matter, the Department had two possible alternatives relative to a Section 304(f) petition in this case. First, given that the fly-over revenue miles (as well as other "nowhere" miles such as international miles) are not being included in any state, the Department could have taken the position that all such miles should be *excluded* from the everywhere denominator. *See* Section 304(f)(2) Second, consistent with their Section 304(d)(1) arguments, the Department could continue to make the more limited argument seeking to include only the Illinois fly-over revenue miles in the numerator. *See* Section 304(f)(3), (4) The Department's arguments were directed towards the latter approach. (Tr. p. 8)

Regarding the first alternative, the Administrative Law Judge agrees with the parties' statements in both the testimony at the original hearing and in oral arguments that exclusion of all "nowhere" miles from the denominator would actually create a distortion *against* the Taxpayer. (*See e.g.* Tr. pp. 7-8, 22-23; R. 25 (testimony of the Audit Supervisor, Mr. Donnelley)) However, as discussed below, reaching this determination to not adjust the denominator and focus only upon the numerator prevents the Department from sustaining its burden of proof by clear and cogent evidence under the second alternative approach.

The distortion under the first alternative would result because the Taxpayer's income is in part reflective of activities throughout its entire route system, domestically and internationally. The Act starts with the Taxpayer's federal taxable income as earned from its entire activities. This can be shown in this case because the amounts from Taxpayer's US-1120 were applied as the starting point on Taxpayer's IL-1120 returns as filed. (R. 217, 253, 320, 393, 452, 533, 825, 898) Even though "nowhere" revenue miles flown

over the Pacific Ocean or Canada would not, by definition, be in the numerator of any state, to fail to reflect those activities in the denominator would create an inconsistency between the measuring of their business activity and Taxpayer's income earned from its various activities. As Taxpayer Ex. No. 14 shows, the amount of international revenue passenger miles ("RPM's") is substantial, over 40% of the total RPM's for TAXPAYER A. (R. 1017)

The Department presented its arguments under the second alternative. Their Section 304(f) arguments were narrowly focused upon the more limited argument of including Illinois fly over revenue miles in the Illinois numerator. (Tr. p. 9) The activities the Department is seeking to reflect in the numerator are the Illinois miles of city pairs that normally fly over the State of Illinois (between the border of Illinois to the other border of Illinois as these flight pairs fly through its route system). (Tr. pp. 10-11)

As noted above, in determining whether the Department has satisfied its burden of proof, the regulations and case law requires a showing "by clear and cogent evidence" that Section 304(d) as interpreted by Judge Kogan reaches a grossly distorted result. The regulations state that this burden will be met *only* if the statutory formula (excluding Illinois fly-over revenue miles from Section 304(d)) is demonstrated to operate "unreasonably and arbitrarily" in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the state and the application of Section 304(f) "fairly and accurately" apportions income to Illinois based upon business activity in the state.

Applying the regulations to the particular facts in this case, the existence of "nowhere" miles alone would not justify the application of Section 304(f). Section 304(f) may not be applied "merely because it reaches a different apportionment percentage than the required statutory formula". Section 100.3390(c) Nor may Section 304(f) be applied merely because the required formula results in a "gap" in apportioning income. Taxpayer's counsel argued that the facts here are consistent with those in *Lakehead Pipe Line Co.*

v. Department of Revenue, 192 Ill. App. 3d 756, 549 N.E.2d 598 (1st Dist. 1989), *appeal denied*, 129 Ill. 2d 564 (1990). (Tr. pp. 31-32) The Administrative Law Judge agrees that the analysis in *Lakehead* is applicable to this case.

As in this case, *Lakehead* involved the interaction between Sections 304(d) and 304(f). In *Lakehead*, a 1.4452% variance between the formula proposed by the Department and the formula proposed by the Taxpayer was not found to constitute gross distortion. *Lakehead*, 549 N.E.2d at 603. In this case, only the TAXPAYER B 1986 year returns (2.7304% and 1.5277%) are above that amount which was found to *not* justify application of alternative apportionment. Further, of those TAXPAYER B returns, the only TAXPAYER B return with a significantly larger range of apportionment percentage difference than what was found to not constitute gross distortion in *Lakehead* was TAXPAYER B's August 12, 1986 return. However, that return may not be reflective because it is a short year return (date TAXPAYER B was purchased by TAXPAYER A) and there may be other issues which explains why the difference results prior to TAXPAYER B being purchased by TAXPAYER A. The evidence here is not "clear and cogent" that application of Section 304(d) as interpreted by the Taxpayer leads to a grossly distorted result.

As noted above, this results because the Taxpayer's revenue mile denominator is so large that an adjustment to the numerator to include the Illinois fly-over revenue miles would not have a large overall impact on the Illinois apportionment percentage. It is recommended to the Director that under the facts of this case, the Department cannot invoke an alternative apportionment under Section 304(f).

III. <u>Section 1005 Penalty</u>.

TAXPAYER A argued in the alternative that if the Illinois fly-over revenue miles in dispute are properly included in their Illinois numerator under the Act, no Section 1005 penalties should be imposed on those amounts. ALJ Tucker sustained the Department's proposed imposition of penalties under Section 1005

of the Act for failure to pay the amount of tax required to be shown on their Form IL-1120's on or before the due date of the return. Penalties were found to be due because he concluded that the Taxpayer's failure was not due to "reasonable cause".

An issue made relevant by Judge Kogan's opinion is whether the Taxpayer had offered sufficient evidence of reasonable cause to abate the Section 1005 penalties proposed in the Notices of Deficiency for the years ended in 1986 through 1987. TAXPAYER A's earlier briefs and evidence in the record are relevant in light of Judge Kogan's Memorandum and Decision. (slip op. at 23) TAXPAYER A relied on its prior briefs and oral arguments, both in the initial administrative hearing and on appeal, as to those issues. (Tr. p. 33; TP Remand Brief at 11)

The Department has not adopted any regulations as to what constitutes reasonable cause to abate the Section 1005 penalty for years ending prior to January 1, 1994. /[7] Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. *See* I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty was imposed. As a result, no penalty should be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. *See e.g Ireland v. Commissioner*, 89 T.C. 978 (1987); *Webbe v. Commissioner*, 54 T.C.M. 281 (1987); *Balsamo v. Commissioner*, 54 T.C.M. 608 (1987).

The Taxpayer argued before ALJ Tucker that even if they are required to include Illinois fly-over revenue miles in the numerator of their apportionment fraction, the resulting underpayment was due to "reasonable case" and they

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[7]. The Department has adopted regulations on what constitutes reasonable cause relating to the Uniform Penalty and Interest Act [35 ILCS 735/3-1 *et seq.*]. *See* Part 700, Uniform Penalty and Interest Act, Subpart D, Reasonable Cause. Under Section 700.400 of the regulations, the most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability. This is considered to be met if the taxpayer exercised ordinary business care and prudence in filing their returns.

should not be subject to the penalty under Section 1005 of the Act. Their reasonable cause argument was based on four main points:

a) Section 304(d)(1) of the Act does not expressly require the inclusion of Illinois fly-over miles in the numerator of the apportionment factor;

b) There has been no regulations promulgated under Section 304(d)(1);

c) There is no Illinois case law on the issue; and

d) There are cases involving the Taxpayer from other jurisdictions which have held that fly-over miles should not be included in an apportionment formula.

TAXPAYER A argued that their reliance on those cases, given the lack of any Illinois law on the subject, constitutes reasonable cause and precludes the imposition of penalties for failure to include fly-over miles in the numerator of the apportionment formula. (*See* R. 1176-1177, 1224-1226; TP Admin Hgs Brief at 15-16, 63-65)

There are at least three portions from Judge Kogan's decision which are relevant to the issue of the imposition of the Section 1005 penalties. Her decision supports TAXPAYER A's contentions that they took a good faith tax return position at the time the returns were filed.

First, Judge Kogan found in favor of the taxpayer on their arguments relative to the statutory language of Section 304(d). This ruling is relevant in that Judge Kogan reached the same conclusion from a reading of the language of Section 304(d): that the numerator of the apportionment fraction only includes Illinois revenue miles which are *in* Illinois and does not include Illinois fly over revenue miles which are *over* Illinois. This finding supports WITNESS C's testimony as to their decision to interpret Section 304(d) in the manner they chose to file (i.e., by taking the position they are not expressly required to include the Illinois fly-over revenue miles). While it is true that the Department is making the contrary argument that Section 304(d) does not expressly authorize TAXPAYER A's reading of the statute either, Judge Kogan's

decision supports the conclusion that the Taxpayer would have exercised ordinary business care and prudence making the decision to take that position on the returns as filed. (R. 120)

Second, Judge Kogan noted the absence of legislative history to determine if the legislature intended to include overflights in the Section 304(d) apportionment formula. (slip op. at 15) This supports the Taxpayer's decision given that there were also no published rules or regulations specifically instructing the Taxpayer on computing Illinois fly-over revenue mileage. Because the Taxpayer examined and relied on the authorities that existed when the returns were filed, and none of the authorities were specifically contrary to Taxpayer's position, Taxpayer exercised ordinary business care and prudence in deciding to interpret Section 304(d) by excluding the Illinois fly-over revenue miles from the numerator of its apportionment formula.

Third, in the "Other Jurisdictions' Authority" portion of her opinion, Judge Kogan noted the rationale with regard to two state court decisions in which fly-over miles were determined to not be includible in the numerator. (slip op. at 18-20) Both involved the Taxpayer as a party and were applied by Judge Kogan to her Section 304(d) analysis. ALJ Tucker had found both cases, *Northwest Airlines v. State Tax Appeal Board*, 720 P.2d 676 (Mont. 1986) and *Republic Airlines, Inc. v. Department of Revenue*, 464 N.W. 2d 62 (Wis. App. 1990) to be distingushable. (*See* R. 1348-1349, fn. 4) /[8] Particularly in the case of the Montana decision (the only out-of-state case which had been issued

[8]. ALJ Tucker noted in his Recommendation that there was an Oregon Supreme Court case, *Alaska Airlines, Inc. v. Department of Revenue*, 769 P.2d 193 (Or. 1989), *cert. den.*, 110 S.Ct. 717 (1990), which analyzed and rejected a distinction between revenue miles "in" and "over" a state. (*See* R. 1350) The *Alaska Airlines* Court held that Oregon fly-over miles were properly includible in the Oregon numerator of the apportionment factor. In objecting to the use of overflight time to determine a portion of the value of aircraft property in calculating their property tax assessments, Alaska Airlines was arguing that Oregon fly-over miles are not "within" Oregon. *See* ORS 308.550(2), 308.555. The *Alaska Airlines* Court specifically addressed and rejected the Taxpayer's argument that an overflight is not "in" Oregon. *See Alaska Airlines,* 769 P.2d at 197-198 However, it should be noted for purposes of this Section 1005 penalty reasonable cause analysis that this decision was issued after the returns in dispute in this case were filed.

before any of the Illinois returns in this case were filed), this supports the Taxpayer's argument that WITNESS C had exercised ordinary business care and prudence in taking a position consistent with those cases. (R. 122)

Relative to the authorities from other states, the analysis for purposes of "reasonable cause" is not whether either is dispositive of this case. (*See* R. 1186-1188; 1224-1226; TP Admin Hgs Brief at 25-27; 63-65) The issue is whether those cases support TAXPAYER A's contention that it had exercised ordinary business care and prudence at the time of filing its returns in order to demonstrate a sufficient showing of "reasonable cause" to abate the Section 1005 penalty in any event.

While it is true that the Department argues in this case that the Montana Supreme Court's decision in *Northwest Airlines v. State Tax Appeal Board*, 720 P.2d 676 (Mont. 1986) is distinguishable due to the procedural manner in which it was presented adminstratively to the Montana Courts and because the result was dependent on issues specific to the three factor Montana statute and regulation involved, the fact is that it was the only published state supreme court decision which had considered the fly-over issue at the time the 1986 returns were filed in 1987. (R. 122) Further, by the time TAXPAYER A's 1987 return was filed in 1988, the issue relative to Illinois fly-over revenue miles and Section 304(d) was in dispute in an Illinois court. /[9]

In addition, Judge Kogan also favorably noted *Republic Airlines, Inc. v. Department of Revenue*, 464 N.W. 2d 62 (Wis. App. 1990) (slip op. at 20) In that case, the issue was whether the Wisconsin statutes authorized the imposition of a sales and use tax on food and beverage transactions taking place on aircraft flying over Wisconsin. The *Republic* Court reviewed the legislative intent of

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[9]. The administrative hearing on the first TAXPAYER A protest had originally been postponed pending the result in *United Airlines, Inc. v. Sweet*, Circuit Court of the Seventh Judicial Circuit, Sangamon County, No. 88-CH-13. The complaint in that case raised the same fly-over miles issue as here. Although the case was dismissed by the parties without a ruling, it is significant relative to Section 1005 penalties for the 1987 year because the issue was in dispute in the Illinois courts at the time the 1987 return was filed. (R. 197, 1052-1054)

the sales and use tax statute's definition of "in this State". *See* W.S.A. Sec. 77.51(6) As in the Montana situation, this indicates that the Taxpayer had a difference of opinion on this issue in another state. This supports the conclusion that the position being taken on Illinois returns as filed was taken in good faith.

It is recommended to the Director that assuming that the fly-over revenue miles are properly includible in the Illinois numerator under Section 304(d), TAXPAYER A has demonstrated that their failure to include Illinois fly-over miles in the Illinois numerator is due to "reasonable cause". Taxpayer had an honest difference of opinion with the Department. Taxpayer's position taken on its returns as to the inclusion of Illinois fly-over revenue miles in the numerator was taken in good faith. Consequently, TAXPAYER A exercised ordinary business care and prudence in filing its returns. Particularly relevant on this record following Judge Kogan's opinion, the Administrative Law Judge finds that the Taxpayer has shown reasonable cause for the positions taken on their returns. It is recommended that Section 1005 penalties be abated.

RECOMMENDATION:

The Administrative Law Judge recommends to the Director of Revenue to uphold and recompute the subject Notices of Deficiency based upon the following findings:

1. After a remand hearing under Section 304(f), a review of the evidence in the record and the burden of proof required by the Department's regulations, it is recommended to the Director that the Department cannot invoke an alternative apportionment method including Illinois fly-over revenue miles in the numerator under the facts of this case. It has not been demonstrated by clear and cogent evidence that applying the statutory Section 304(d) formula (assuming that a proper interpetation of Section 304(d) is in fact that Illinois fly-over revenue miles cannot be included in the numerator) leads to a grossly distorted result which would allow the Department to apply Section 304(f) in the

alternative. Given the size of TAXPAYER A's denominator, the Department is unable met its burden of showing that the statutory Section 304(d) formula as found by Judge Kogan operates unreasonably and arbitrarily in under-attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the State of Illinois.

2. It is recommended to the Director, assuming that the fly-over revenue miles are properly includible in the Illinois numerator under Section 304(d), that TAXPAYER A has offered sufficient evidence of reasonable case to demonstrate that their failure to include fly-over miles in their Illinois numerator is due to "reasonable cause", therefore, the Section 1005 penalties should be abated.

Date:_____

_____
James P. Pieczonka
Administrative Law Judge